REAL ECONOMY

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GOVERNANCE

No major changes on the political front: the budget process seems to be muddling through amidst mutual finger pointing and public diatribes exchanged between the coalition partners. At the moment this issue of the **Real Economy** became public the budget was already approved. However, the nature of the process is revealing in itself. Firstly, it shows that ruling in coalition is no easy walk even after almost two years have passed since the democratic coalition came to power. In other words, this cumbersome cohabitation will continue for some time before the coalition learns to communicate better, internal competitions settle and roles become more or less agreed. The tensions will perhaps recede after the local elections, but only somewhat. Secondly, for this sanguine scenario to materialize rather sooner than later, we need to have clear understanding of the motivations behind the current unease.

Apparently a couple of versions, not mutually exclusive, may be applied. The first one views the situation from the standpoint of a bitter struggle between core vested interests coalescing around different parties. Such a scenario does not bode well for the coalition since it means that any resemblance of stability would ensue only once one of the 'partners' is damaged beyond repair. Otherwise the infighting will continue and eventually flare up since the parties are also in command of different, autonomous and less so, control and regulatory agencies to conduct the animosities down to the core. The second standpoint is much more benign. The situation may be analytically treated as a tag-of-war in which parties try to gain as much as possible in the process of distribution of roles and leverages within the coalition. Once settled, the story goes, the infighting will subside. The third standpoint is a combination of the first two. Currently we indeed witness the tag-of-war which however serves as a proxy for the future conflicts between core vested interests; its outcome will ultimately show who is in pole position for this later stand-off. Again, such situation is of bad augur for the ruling coalition, political stability and reform agenda of the country.

The political infighting should not eclipse some economic reforms being promoted by the Government. One of such instances is proposed amendments to the Law on public property management and privatization. The amendments to the law are important themselves as they streamline privatization process, devolve more competences to local authorities and try to safeguard public interests in privatization process. However, the amendments made to the list of the enterprises not liable to privatization are no less significant. In certain sectors the eventual privatizations are needed not only for usual mix of reasons: raising budget revenue, eliminating drain on public resources by loss-making public enterprises, as well as respecting international commitments. Some of these privatizations are crucial for reforms to move on in certain sectors. The

In this issue:

- Ruling coalition: on a bumpy road;
- 'Surprising' industrial growth;
- Economic crisis' uneven social impact;
- Foreign trade: a sober look at expanded wine quotas;

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REAL ECONOMY *is a monthly economic review tracking the most important policy and economic evolutions. Its readers are policymakers, CEOs of domestic and international companies and banks, representatives of the international institutions and foreign embassies, political parties and economic journalists.*

Used acronyms and abbreviations:
y-o-y - year on year; q-o-q - quarter on quarter; Q4'07 – fourth quarter 2007; Jan'09 – January 2009; NBS – National Bureau of Statistics; NEA – National Employment Agency; NBM – National Bank of Moldova; EG – Expert-Grup; MDL – Moldovan leu (national currency); p.p. – percentage points;

EXPERT-GRUP *is a Moldovan policy think-tank whose mission is to create a working environment in which free and non-trivial thinking thrives in order for the institution to be a leading source of unbiased economic analysis and to effectively advocate for innovative ideas and solutions to the economic problems that Moldova encounters along its path of economic transformation, societal development and European integration.*

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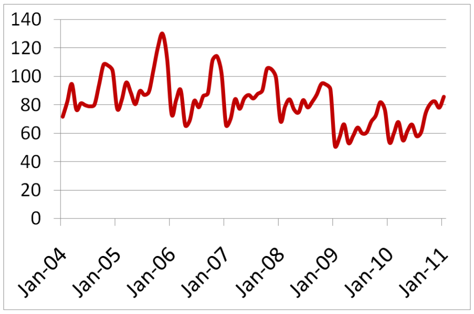
best example is probably offered by the extension of the privatization process in the energy sector. As Moldova faces a tall order of tasks to fulfil as part of its euro-integration efforts in this area, liberalization of the sector and attraction of private investments become critical. At the same time, privatizations are not a cure-all drug, and in some cases it will not be able to proceed while a constellation of already accumulated problems waits to be solved, such as debt juggernaut in the thermal energy sector in the capital.

REAL SECTOR

Figure 1. Industry output index, %, Dec'03=100%



Source: NBS and EG calculations;

Very optimistic statistical data have been recently released on the industrial output in January 2011. According to the new data, in the first month of the current year the Moldovan industrial sector has seen a 10% y-o-y monthly economic growth, double above the respective figure for 2010. However, with a closer look into the historical data, an optimist gets sober. Indeed, in terms of real output, in January last year the Moldovan industry was still very close to its historical minimum (Figure 1). That minimum was reached in January 2009 as result of the combined effect of the global financial crisis and the sector-specific recession that Russian Federation triggered in 2006 after introducing its trade embargo against some of the key Moldovan exports: wine, vegetables, animal products. Thus, the recent 'spectacular' growth is to a significant extent due to the very low comparator base in 2010, an effect which we expect to gradually level out as we are nearing the end of the year.

Table 1. Output volume index in some industrial sectors, Jan'10 and Jan'11, % y-o-y

	Jan'10	Jan'11	Jan'11 / Jan'09, %
Industry total	105.0	109.8	115.3
Mining & quarrying	26.7	385.6	103.0
Fruits and vegetables proc. and preserving	66.6	389.8	259.6
Metallurgy	38.0	320.3	121.7
Machines and equip.	67.3	192.7	129.7
Optical, medical and precision equipment	60.9	175.8	107.1
Leather proc., footw.	80.5	169.7	136.6

Source: NBS and EG calculations;

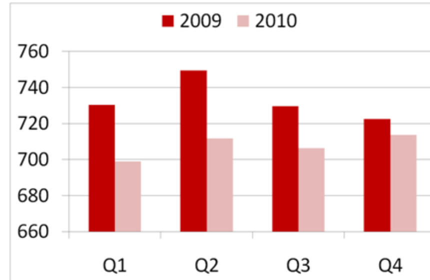
With the factor of low base in mind, it is no surprise that the highest growth rates happened to take place in those sectors which in 2010 experienced the deepest declines in production (Table 1): in Jan'11 the index of output in mining and quarrying industry was 385.6% y-o-y (after a devastating 27% in Jan'10), processing and preserving of fruits and vegetables - 389.8% (67% in Jan'10), metallurgical industry – 320% (38% in Jan'10). At the same time, as the third column is the Table 1 suggests, at least half of the recent growth is certainly 'real' growth, helping more than recovering the output levels reached in Jan'09. However, further evolution in the export-oriented industrial sector will very much depend on the economic prospects of the regional markets, some of which are continuing bleeding after the global financial turmoil. At the same time, the negative evolutions in the energy sector, particularly in domestic production of electricity are more than noteworthy (-8%); this decline is another testimony of the highly inefficient domestic producers, thus making a good case for the recently announced Ministry's of Economy plans of privatization in the energy sector. Among other state owned enterprises proposed to be privatized there are three cogeneration power plants and two electricity distribution networks.

For exactly the same reason of low comparator base, the growth in volume of goods transported in Jan-Feb'11 was 63% y-o-y. This growth was due both to significant recovery in transported cargo by automobile (+65%) and railroad mode (+60%). Among other transported goods, the growth in transported volumes of cereals and bakery products (+64.5%) is more than remarkable. The passenger transport services, while growing at a more temperate speed than the goods sub-sector, continues gathering steam, with the recession period ending back in September last year.

HOUSEHOLDS

According to recently reviewed statistical data, in 2010 the real wages rose by 0.7%, registering the lowest increase since the economic recovery in Moldova took ground. This is the outcome of delayed crisis on the labour market that reached its peak in 2010, with a constant decrease in wages during the first semester of the year. Although it might be read as a sign of recovery the enterprises got through significant 'optimization' processes (including shedding labour and migrating to the informal economy). The number of employees in formal enterprises decreased during the whole year (Figure 2), with implications on the employees' remuneration fund and consequently on Social Insurance and Mandatory Medical Insurance funds revenues.

Figure 2. Number of wage earners in formal enterprises, thousand



Source: NBS;

Another important development is linked to the rise in wage inequality between economic sectors. If prior to the economic crisis wages had a moderate convergence trend across the economic sectors, in 2010 the dispersion of average wage per economic sectors increased. Thus, wages in wholesale and retail trade (employing a large share of population) and health sectors decreased being presently under the national average; on the other hand, wages paid in financial institutions, real estate companies and some industrial branches rose (being over 15% above the national average). However, it is important to mention that salaries in agricultural and education sector that are still far below the national average (55% and 80% respectively) advanced slightly.

The recent creation of Syndicate of Unemployed is an interesting development that should not be neglected. Although unusual by name, it is not completely uncommon as unemployed associations exist in other countries too. The usual responsibilities of such an organization are to: (i) promote the interest of unemployed at national level; (ii) increase the living standards of unemployed by promoting increases in the level and duration of unemployment benefits; (iii) build links between unemployed and employers association, national and international bodies. There is no much official information available (such as the statute) that will make it clear what is the main goal of the syndicate and the methods that will be used to achieve it. Another important aspect is the source of financing of such an organization. International experience shows few sources of finance: state budget (through Ministry of Social Protection or Ministry of Labour), members' contributions and services provided by the association (such as trainings). The financing strategy of the Moldovan syndicate of unemployed is not known, but in case it is financed by a single body or person (as there are already rumours), it risks becoming another tool for promoting a political party interests rather that the needs and interests of unemployed.

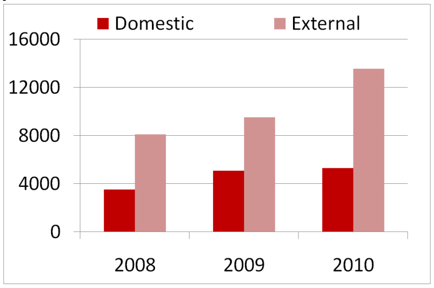
PUBLIC FINANCE

A week after the government had finally approved the state budget law the speaker of the Parliament Marian Lupu declared that the Parliament would approve the law in question by the end of March. According to the approved law of state budget, in 2011 the budget revenues will constitute 19.07 billion lei while the budget spending, 20.35 billion lei. It is expected that in 2011 the budget deficit will account for 1.9% of the GDP. In case these prospects turn out to be true, in 2011 Moldova will have the lowest budget deficit as percentage of GDP in the past 3 years.

On 16 of March the Ministry of Economy held a round table with a focus on the ***proposed amendments of the Law regarding the management and privatization of state owned enterprises*** No. 121-XVI / 04.05.2007. During the meeting, the representatives of the public and private sector were offered the opportunity to voice their opinion on the specific amendments and the list of state owned entities proposed for privatization. The host of the meeting, Minister Valeriu Lazar, has specifically stated that the funds obtained from the privatization of state owned companies will be used for financing the budget deficit.

According to newly released statistical data, at the end of 2010 the public debt constituted 26.3% of the GDP, thus registering an increase of 2.1 p.p. as compared to the corresponding figure of 2009. In 2010 the public debt was composed of 71.9% external debt and 28.1% internal debt. In this regard it is worth mentioning that the overall public debt has registered some structural changes - as compared to the data registered in 2009 the share of the external debt has increased with 6.8 p.p. Such an evolution can be partly explained by the acute need of funds necessary for covering the state budget, with cheaper resources available abroad rather than domestically.

Figure 3. Evolution of the Moldova's public debt, MDL million

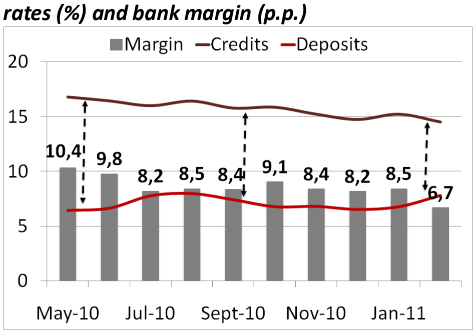


Source: Ministry of Finance;

FINANCIAL SECTOR

The economic recovery continued to fuel the demand for banking loans, while banks are becoming less reluctant in crediting real sector. Thus, in February this year the amount of new loans in national currency increased by 6.9% in y-o-y terms, mainly because of consumer loans (+66.9%). The firms contracted a 1.8% lower volume of loans in MDL; however, it was partly due to the possibility for exporters to access foreign currency loans. As a result, the amount of such loans contracted by firms increased by 65.8% in y-o-y terms during the same period.

Figure 4. Bank' average lending and deposit rates (%) and bank margin (p.p.)



Source: NBM and EG calculations;

The bank loans became cheaper, on the grounds of decreasing risk premiums. In February, the average interest rate on bank credits in national currency was 14.53%, by 0.71 p.p. less than in January and by 3.25 p.p. less in comparison with previous year. It can be explained by the adaptive stance of monetary policy, as well as by the decrease in risk premiums (Figure 4) due to the improvement of country's macroeconomic situation.

Nevertheless, the banking system remains abundant in idle liquidities, bearing significant opportunity costs. It explains the increase in demand of banks for Treasury bills in February in comparison with the previous month, with the demand for the 3 types of T-bills going up 12.2% on average. It also reveals the yet untapped potential of crediting the real economic sector and persisting deficiencies in financial intermediation by commercial banks.

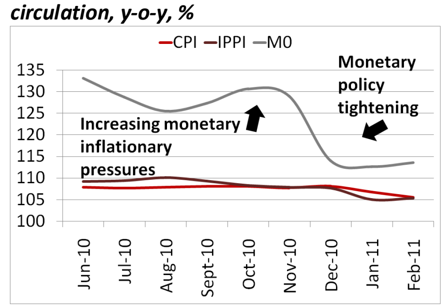
In short term we expect a further increase in interest rates on deposits, a slight decrease in risk premiums and bank margins and more or less stable interest rates on credits. The resumption in lending activity during the current year is likely to fuel banks' demand for new resources, which could reflect in increasing interest rates for deposits. Additionally, the economic recovery and financial health improvement of bank's current and potential clients could motivate banks to reduce further the risk premiums which tripled during the financial crisis period. Declining risk margin will counterbalance the increase in interest rates on deposits, which will have negligible effects on the costs of credits.

MONEY AND PRICES

The monthly inflation rate in February was mainly determined by the increase in prices for municipal services. As a result of administrative decisions undertaken due to higher prices for imported gas, the central heating became 21.5% more expensive than in January, gas supply - 5.5%, water supply –3.0%. Overall, the driving factor of monthly CPI was the increase in prices for services (+2.6%), followed by foodstuffs (+1.2%), while the prices for non-foodstuff almost did not change (+0.2%).

The price growth continues to be shaped by imported inflation and seasonal factors. Thus, the inflation of foodstuffs was driven by the evolution of prices on foreign markets which fuelled the domestic prices of potatoes (+14.0%), corn flour (+2.4%) and wheat flour (+1.6%); due to seasonal factors, vegetables and fruits became 4.3% and, respectively, 3.0% more expensive. We reiterate our view expressed in the **Real Economy** nr.17 that such a strong inflation of prices on socially important products is the key factor jeopardizing the wellbeing of households living below or near the poverty line.

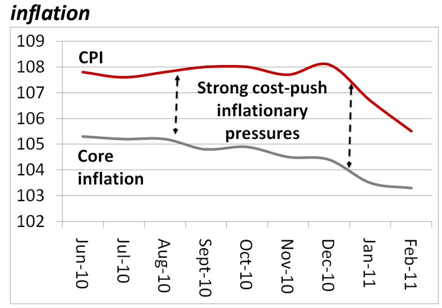
Figure 5. Evolution of CPI, industrial producers' prices index and money in circulation, y-o-y, %



Source: NBM, NBS and EG calculations;

Monetary inflationary factors persist, as the y-o-y growth of money in circulation (M0) is significantly exceeding the CPI (Figure 5). It is explained by the economic recovery associated with a revival in domestic consumption and banks' lending activity. In order to mitigate these pressures, the central bank intensified its sterilization operations, while keeping an adaptive monetary policy stance. As in the previous months, the efficiency of these interventions was undermined by the strong cost-push factors, revealed by the gap between CPI and core inflation (Figure 6).

Figure 6. The gap between CPI and core inflation



Source: NBS;

The annual CPI returned into the targeted interval, posting a growth rate of 5.5%. However it is likely to be a temporary phenomenon as it is still partly determined by the high comparison base due to strong increase in prices in 2010. In fact, we expect the indicator to approach the level of 7.0% – 7.5% by the end of the year. The main inflationary pressures will be generated by the 2nd round effects of current increase in prices for utilities, prices on external markets of fuels and foodstuffs and consumption recovery.

FOREIGN TRADE

In 2011 the EU opened its doors even wider for Moldovan wines. Thus on March 24 the European Parliament voted increase in tax-free quota for Moldovan wine by 80% (as compared to 2010) up to 1.5 million dekalitres. Obviously, this decision should not be viewed as a simple 'quantitative expansion'. Rather, it is a political gesture of support for Moldovan government and wine-makers to ease difficulties and apprehensions related to the negotiations on the DCFTA as well as to mollify the eventual adverse impact of trade barriers installed by Russian Federation.

However, short-term expectations of an eventual beneficial impact of this decision should not be overstated. The increase in quotas does not necessarily mean that Moldovan producers either will be able automatically use them fully in 2011 or simply redirect this quantity from Russian to EU market in case the trade barriers appear. If 2010 is of any guide, it is very probable that Moldovan wine-makers will fail to use these quotas fully. They could not do it in 2010 and it is not clear why they should be in 2011. This sober view is supported by some wine-makers who expect increasing their wine exports to the EU by 10% at best in 2011. Furthermore, our simulations based on a Moldova CGE model show quite marginal short-term impact of increasing quotas with Moldovan wine exports to the EU rising by 1.5-3% under various scenarios[1].

By the same token, the long-term effects should be quite positive. The increasing wine quotas coupled with growing technical and financial assistance both to wine-makers and quality ensuring institutions could help 'resetting' the wine-sector and spur moving it on the sustainable path. More private investment (especially from the EU) and accommodating state policies would certainly help. The last, but in anyway not the least, promoting wine exports to the fast growing emerging markets, outside the CIS and EU, would also provide an important fillip to the modernization and competitiveness of the sector.

[1] Alex Oprunenco, "The Impact of the Russian Wine Embargo: Estimation of Economic Impact", Expert-Grup, 2011.

STATISTICAL APPENDIX

TABLE 2. MOLDOVA: KEY SHORT-TERM ECONOMIC INDICATORS

	Jun'10	Jul'10	Aug'10	Sep'10	Oct'10	Nov'10	Dec'10	Jan'11	Feb'11	Mar'11
Industrial production growth rate, y-o-y, %	8.8	-0.2	2.3	13.9	16.8	7.6	2.3	9.8	n.a.	n.a.
Retail-trade growth rate, y-o-y, %	8.3	8.9	9.7	8.1	11.4	12.7	9.2	n.a.	n.a.	n.a.
Services to population growth rate, y-o-y, %	0.2	2.4	-1.4	3.0	6.1	7.2	6.6	n.a.	n.a.	n.a.
Merchandise exports, million USD	99.1	118.5	122.6	149.5	179.2	204.8	186.9	n.a.	n.a.	n.a.
Merchandise imports, million USD	322.7	314.0	301.5	345.0	373.4	405.4	439.9	n.a.	n.a.	n.a.
Official reserve assets, million USD	1421.6	1507.5	1551.4	1619.3	1645.4	1610.9	1717.7	1744.5	1739.8	n.a.
Registered unemployed, persons, end-period	49530	47412	46216	43329	41333	39943	40719	44170	50095	n.a.
Real wage growth rate, y-o-y, %	0.4	0.7	2.2	0.9	1.7	2.8	-1.0	n.a.	n.a.	n.a.
Budget revenues growth rate, cumul. y-o-y, %	14.5	13.7	14.1	15.4	15.1	14.6	18.5	n.a.	n.a.	n.a.
Consumer prices growth rate, y-o-y, %	7.8	7.6	7.8	8.0	8.0	7.7	8.1	6.7	5.5	n.a.
Nominal exchange rate, end-period, MDL/USD	12.84	12.27	12.20	12.02	11.81	12.12	12.15	11.98	11.99	11.90
Nominal exchange rate, end-period, MDL/EUR	15.65	16.06	15.43	16.34	16.36	15.96	16.10	16.44	16.53	16.82
Broad money (M2) growth rate, y-o-y, %	22.41	22.29	22.07	22.53	29.42	25.47	18.36	17.33	n.a.	n.a.
Central bank refinancing rate, end-period, %	7.0	7.0	7.0	7.0	7.0	7.0	7.0	8.0	8.0	8.0
Bank deposit rate, %	6.65	7.79	7.99	7.43	6.79	6.82	6.54	6.79	7.82	n.a.
Bank lending rate, %	16.46	16.02	16.44	15.80	15.88	15.24	14.76	15.24	14.53	n.a.
Banks liquid assets, % of total assets	34.81	33.94	33.59	34.05	33.19	33.36	34.15	34.62	n.a.	n.a.
Banks unfavorable credits, % of total credits	17.47	17.83	17.38	15.67	15.23	14.80	13.33	13.39	n.a.	n.a.
Currency deposits, % of total deposits	49.75	49.70	49.00	48.88	48.32	47.92	48.45	48.55	n.a.	n.a.

Source: NBS, NBM and EG calculations and estimates;

TABLE 3. MOLDOVA: KEY LONG-TERM ECONOMIC INDICATORS

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Population, million (excludes Transnistria), end year	3.628	3.618	3.607	3.600	3.590	3.581	3.573	3.568	3.563
GDP, billion USD, current prices	1.662	1.981	2.598	2.988	3.408	4.401	6.055	5.403	5810
GDP per capita, USD at PPP	1761	1923	2126	2359	2559	2720	3004	2839	n.a.
GDP growth rate, y-o-y, %	7.8	6.6	7.4	7.5	4.8	3.0	7.2	-6.5	6.9
Private consumption growth rate, y-o-y, %	5.9	18.5	6.2	10.1	7.0	3.6	4.5	-7.9	9.0
Gross fixed capital formation growth rate, y-o-y, %	1.1	19.2	11.0	17.7	2.8	10.5	-7.8	-37.2	17.2
Industrial production growth rate, y-o-y, %	10,8	15.6	8.2	7,0	-4.8	-1.3	0.7	-22.2	7.0
Agricultural production growth rate, y-o-y, %	3.4	-13.6	20.8	0.8	-1.1	-23.1	32.1	-9.9	7.9
Share of industry in GDP, %	20.2	20.5	20.5	19.1	18.0	19.1	13.9	13.0	13.3
Share of agriculture in GDP, %	21.0	18.3	17.5	16.4	14.8	10.0	8.8	8.5	12.0
Merchandise exports, million USD	659.7	805.1	994.1	1104.6	1060.8	1373.3	1646.0	1321.5	1582.1
Merchandise imports, million USD	1037.5	1428.1	1748.2	2296.1	2644.4	3676.4	4866.3	3333.0	3855.3
Service exports, million USD	216.65	249.93	332.08	398.94	465.66	625.08	837.2	677.7	n.a.
Service imports, million USD	256.99	294.26	353.05	419.68	487.64	631.16	824.72	701.8	n.a.
Net foreign direct investment, million USD	83.6	73.64	147.8	190.86	234.16	522.04	691.49	112.0	n.a.
Net work remittances, million USD	286.3	440.2	659.5	868.8	1119.0	1419.4	1795.8	1342.4	n.a.
Current account/GDP, %	-4.0	-6.6	-2.2	-8.1	-11.7	-15.2	-16.7	-8.6	n.a.
Official reserve assets, end-year, million USD	268.87	302.27	470.27	597.44	775.3	1333.7	1672.4	1480.3	1717.7
Total external debt stock, million USD	1816.5	1929.4	1881.8	2078.1	2528.9	3355.9	4106.1	4368.8	4618.1e
External debt/GDP, %	109.3	97.5	72.5	69.6	74.3	76.3	67.9	80.8	n.a
External debt/exports of goods and services, %	198.2	182.2	141.5	138.0	164.8	167.4	164.6	215.1	n.a
Employment rate, % of population aged above 15	53.3	47.5	45.7	45.4	42.9	42.5	42.5	42.8	38.5
Unemployment rate, % of economically active population	6.8	7.9	8.1	7.3	7.4	5.1	4.0	6.4	7.5
Real wage growth rate, y-o-y, %	20.9	15.4	10.1	6.8	14.2	8.0	10.2	9.0	0.7
Consumer prices, year average, %	5.2	11.6	12.5	12.0	12.8	12.4	12.8	0.0	7.4
General government balance, % of GDP	-2.2	1.0	0.4	1.5	-0.3	-0.3	-1.0	-7.0	-2.5
General government expenditure, % of GDP	31.5	33.1	35.1	37.0	40.1	41.8	41.6	43.5	40.8
Exchange rate, year average, MDL per USD	13.6	13.9	12.3	12.6	13.1	12.1	10.4	11.1	12.4
Broad money (M2) growth rate, y-o-y, %	30.4	24.4	44.8	36.7	12.2	47.3	18.3	-3.8	18.4
Central bank refinancing rate, end-year, %	9.5	14.0	14.5	12.5	14.5	16.0	14.0	5.0	7.0
Total commercial bank loans, % of GDP	27.9	28.5	30.3	30.2	33.6	40.2	39.8	41.4	37.2
Bank deposit rate, average per period, %	14.4	12.7	15.2	13.0	11.9	15.1	18.1	14.7	7.56
Bank lending rate, average per period,%	23.1	19.2	21.0	18.9	18.2	18.9	21.0	20.3	16.25

Source: NBS, IMF, NBM and EG calculations and estimates;